9Questions - Tyler Wallace, Fair Oaks Capital

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***9Questions** is our Q&A series featuring key decision-makers in leveraged finance — get in touch if you know who we should be talking to!*

In this edition of 9Questions, we speak with London-based Tyler Wallace, Managing Director and Portfolio Manager at Fair Oaks Capital.

1. The loan market has rallied in recent weeks after a sell-off lasting several months. How has this changed the value propositions for the opportunities you see?

We think the August rally in secondary loan prices is technically driven by recently priced CLOs. It appears most of the CLOs that priced in July had relatively low-ramped warehouses (e.g. <25% ramped) and managers would need to acquire a significant amount of assets in the secondary market between the CLO pricing and closing dates. Issuing a low-ramped CLO is the equivalent of shorting the loan market with the expectation you can acquire loans at current (or lower) price levels over the period between pricing and closing (e.g. six weeks). The rating agencies usually require a minimum percentage of purchased assets at closing (e.g. 75%) so effectively the post-pricing CLO

becomes a forced buyer. If several low-ramped CLOs price at the same time (like what we noted in the second half of July) – you may get a rapid increase in loan prices.

Prior to the run-up in secondary loan prices, we were actively trading our CLOs by focusing on relative value asset switches. We have fixed rate bond capacity in all of our CLOs and we believe adding fixed rate exposure is one way to generate excess par without adding additional credit risk. With the challenging macroeconomic backdrop, we prefer to generate excess returns by adding some duration risk rather than increasing credit risk. After the recent loan price movements, we are now also looking at outright selling loans to reduce credit risk and raise cash for primary issuance (or for future loan price volatility).

2. **Lead banks leaned heavily on private debt markets in recent months to get some LBOs over the line — how do you see that dynamic developing in the second half?**

During 1H22 private lenders stepped in to fill the void left by the lack of new CLO issuance to support the primary loan market. We think direct lenders will continue to be active on the existing/underwritten LBO pipeline. With regards to new LBOs originated post the Ukraine invasion — direct lenders will still be active and we may see hybrid deal structures incorporating loan, bond and private debt investors. New structures may include leveraged loans, FRNs and a private debt portion (e.g. in lieu of unsecured fixed rate bonds).

3. **Macro pressures, such as inflation and supply chain woes continue. Which sectors do you see experiencing more stress in H2 and, conversely, which sectors provide opportunity?**

European corporate and consumer sentiment has weakened over 1H22 and we expect this to continue for the rest of 2022 and into 1Q23. This winter could be especially challenging given the European energy situation. Consumer-facing sectors (e.g. retail, leisure, travel) are already fragile and companies operating in these industries will struggle over the near-medium term. We also think some traditionally defensive sectors (e.g. food producers) will face ongoing pressures on revenues (stagnating/declining volumes), profitability (energy, labour costs) and cash flow (inventory build-up).

With this macroeconomic backdrop we like companies with pricing leverage or companies offering value-oriented products/propositions. Companies caught in the middle end up being price-takers

and will struggle to generate free cash flow. We continue to see interesting opportunities in healthcare & pharmaceuticals, high tech industries and business services.

4. **There are big hopes for a return of primary loan issuance come September — what types of deals and issuers do you expect to characterize H2?**

We expect September and the first part of October to provide a window for primary loan issuance ahead of the 3Q22 financial reporting period. The syndicated amounts of the existing loan pipeline may be less than expected considering some of the deals are being re-cut with TLAs and direct lenders are still active.

Away from the announced public pipeline we think there will be some add-on financings — but 2H22 new issuance volumes may be muted. New transactions may come from issuers in relatively defensive sectors with hybrid debt structures. We believe arrangers will try to include as many investor types as possible. Unfortunately, we do not think loan documentation will materially change until restructurings pick up.

5. **CLOs have had a difficult year with liability stacks remaining wide and issuance low, plus tranche pricing lagging compared to the rebound in secondary loans. Can the CLO loan buying engine be restarted and, if so, how?**

Now the European CLO machine feels a bit stuck in neutral. If CLO liabilities start to tighten and the equity returns make sense – we think CLO primary issuance will quickly resume. New CLO issuance should be supportive for the primary and secondary loan markets. If loan syndication teams feel the new issue loan demand is there, then this will feed through to the sponsor coverage teams who will then actively pitch sponsors. Obviously, this is all predicated on sponsors finding attractive opportunities – but historically when the financing is available, sponsor activity picks up.

6. **Many leveraged loan investors complain of an illiquid secondary market. How has this impacted your strategy in recent months and do you see liquidity returning?**

The secondary loan market is functioning, but faces limited liquidity. This is driven in part by relatively low dealer inventories and limited primary issuance. We are actively trading loans and bonds in this environment, but we find patience and price-discipline are required to execute any

trade, particularly when we are working on loan/bond switches, and we need to line up two separate trades as close as possible.

We think the liquidity situation may improve post-summer, particularly if primary new issuance starts to pick up. Navigating 2Q22 and 3Q22 corporate financial reporting may be challenging if liquidity remains thin. Certain names will hit air-pockets of illiquidity where the price may quickly gap based on news flow and limited trading. We expect price dispersion in the secondary loan market to increase during 2H22 and into 2023.

7. **Inflation is the talk of the town. Are there any other causes of stress that you think are not getting the attention they deserve?**

The Ukraine war may create further periods of stress – especially with regards to energy security in Europe. We fully expect energy rationing to be introduced throughout Europe over the coming winter period. We recently completed sector/industry reviews focusing on the credits we anticipate will be impacted by energy shortages/rationing. As we focus on the large-cap loan space, most of the companies we invest in operate globally and have already taken steps to shift production to less impacted geographies. All of these measures will come at a cost, and we expect further pressure on operating margins and free cash flows across the portfolio.

Looking further out, we think social instability may become a risk in 2023. The global cost of living crisis combined with political polarization may result in pockets of social unrest in both developed and emerging economies. At a minimum, this may create further stress on European credits already impacted from several years of business disruptions from the Covid-pandemic and the subsequent supply-chain issues.

8. **How does Fair Oaks differentiate itself from other CLO shops in the current market?**

At Fair Oaks there is a strong feedback loop between our investment analysis and portfolio management. This feedback loop combined with a focus on limiting absolute credit losses drives our disciplined approach to managing CLOs. We also overlay our sector/industry views with our fundamental credit analysis. For example, we run zero retail sector exposure across the CLOs. We do this because we think most retail business models don’t support significant amounts of leverage and historical recoveries in the sector have been low.

With regards to trading in the CLOs, we focus on being nimble and aim to move quickly to exit underperforming positions. We do not run large, concentrated positions and this enables us to

move in and out of credits without moving the secondary loan/bond markets.

Ultimately, we think a disciplined approach to CLO management is accretive to all CLO investor classes (e.g. both CLO debt and equity investors).

9. **And when you step away from the LevFin world, what would we find you up to on an average weekend?**

Chauffeuring my children to various activities.